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BOE PREVIEW - PREPARING MARKETS FOR ANOTHER RATE HIKE SOON

Berenberg Macro Flash

AT THE FEBRUARY INFLATION REPORT, THE BOE WILL PROBABLY LOOK TO PREPARE MARKETS FOR A MAY HIKE

Following on from on our above-consensus forecasts for UK growth since the Brexit vote, in July 2017 we predicted that the BoE (Bank of England) would surprise markets with an early tightening cycle beginning in November last year. When the BoE finally hiked its bank rate by 25bp in November, this came as a bit of a surprise for markets that seemed to be focusing more on downside risks to demand from Brexit than the signs of growing underlying inflationary pressure. The second part of our July outlook for monetary policy remains unchanged; that BoE will follow up with two more hikes in 2018, once in May and another in November. The market is now increasingly coming around to this view. Bloomberg data show that traders are now pricing in a 60% chance of a rate hike in May, up from 15% in December 2017. The critical question at the February Inflation Report on Thursday is as follows: will the BoE seek to squash these growing expectations or verify them?

For the likely policy direction, the trend is the market's friend. While the BoE is concerned that the short-term risks to demand from Brexit uncertainty could suddenly begin to manifest more seriously, as demand growth is holding up well, and underlying inflationary pressures are rising, its tolerance for above-target inflation is low. Although the BoE initially responded to the risks to demand from the Brexit vote by easing its policy in August 2016, its policy has become increasingly hawkish, driven by the better-than-expected data over time. The BoE takes any directional change in policy seriously. Inflation and interest rate expectations that shift erratically are bad for economies and markets. This is the logic that underpins global central banks' common frameworks for inflation targeting. As the economic data is stronger at the start of 2018 than in mid-2017 when the BoE last prepared markets for a hike, it seems likely that the BoE will continue with its policy tightening this year.

It is getting harder and harder for the BoE to justify its easy policy stance over time. Latest data shows an improving economy. The latest batch of GDP data showed that growth accelerated over the course of 2018. This year, the UK will probably outperform market expectations again. As long as the UK avoids a cliff-edge Brexit in 2019, GDP will probably expand in 2018 and 2019 at the 1.8-1.9% pace of the past two years. With the still strengthening global backdrop, risks to this outlook seem skewed to the upside. At 4.3%, unemployment is below the BoE's estimate of full employment in the labour market (4.5%). Strong labour demand and an increasing mismatch between the skills of the remaining workers and the skills demanded by employers is causing wage growth to accelerate. Average weekly earnings rose by 2.5% yoy in November, up from below 2% in mid-2017. Over time, higher pay will begin to pull harder on inflation. Without rate hikes, the headline inflation rate will not fall from its current rate of 3% to the BoE's 2% target within the BoE's preferred policy horizon (around two years).

HOW COULD THE BOE SIGNAL THAT IT EXPECTS TO HIKE IN MAY?

The BoE has three tools it could employ to either confirm or squash growing market expectations that it is heading for a May rate hike.

1) **Upgrade its economic forecasts:** For inflation-targeting central banks, the economic forecast is the most important forward guidance for markets. In its November Inflation Report, the BoE signalled that the "speed limit" the UK economy can manage without gener-

ating excess inflation is a little over 1.5%. The BoE could thus raise its economic forecast further above this speed limit (Table 1), while projecting that inflation will remain above the 2% target for the forecast horizon (Table 2), and that the labour market will remain above the BoE's estimate of full employment (Table 3).

2) **Have some MPC members vote for rate hikes:** In the months ahead of the November hike last year, the number of MPC (Monetary Policy Committee) members voting for a rate hike gradually increased. This helped to build up market expectations for the eventual hike in November. At the February Inflation Report, at least two of the more hawkish committee members, probably Ian McCafferty and Michael Saunders, could vote for a rate hike.
3) **Comment on market pricing directly:** Ahead of the November hike, the forward guidance in the monetary policy meeting minutes from the preceding months said: "Monetary policy could need to be tightened by a somewhat greater extent over the forecast period than current market expectations." The MPC could once again adjust market expectations as it sees fit in this more direct fashion.

Remember, the MPC has a meeting in March, between the February and May Inflation Reports, that it could use to further adjust market expectations if necessary.

POLICY OUTLOOK AND ECONOMIC IMPACT

We look for two hikes in the Bank Rate in 2018, one in Q2 and one in Q4, followed by one in Q3 2019. Even with a modest continued tightening in which the Bank Rate increased to 1.25% by the end of 2019, UK monetary policy would remain highly accommodative. In our base case, which seems consistent with the BoE's guidance for "gradual" and "limited" rate hikes, the real policy rate would remain negative and the bank's balance sheet large by historical standards. We also note that the costs of business and consumer credit and mortgages are set by market forces, not directly by the BoE. The rise in borrowing costs in the real economy is, therefore, likely to be less than any eventual increases in the Bank Rate.

The risks to the outlook for a gradual monetary tightening depend on the outlook for wage growth. Continued tight labour market conditions point to rising nominal wage growth toward 3% by late 2018 from current rates of around 2.5%. We expect the BoE to tighten by more (or less) than our base case if wage growth surprises to the upside (or downside).

Table 1: GDP (yoy %)	2017	2018	2019	2020
BoE Nov. 2017	1.6	1.6	1.7	1.7
Berenberg	1.8	1.8	1.9	

Table 2: CPI (yoy %)	2017 Q4	2018 Q4	2019 Q4	2020 Q4
BoE Nov. 2017	3.0	2.4	2.2	2.1
Berenberg	3.0	2.5	2.2	

Table 3: LFS unemployment rate (%)	2017 Q4	2018 Q4	2019 Q4	2020 Q4
BoE Nov. 2017	4.2	4.2	4.2	4.3
Berenberg	4.3	4.3	4.3	

Table 4: Bank rate (%)	2017 Q4	2018 Q4	2019 Q4	2020 Q4
BoE Nov. 2017 (market implied path)	0.5	0.7	0.9	1.0
Berenberg estimates	0.5	1.0	1.25	

Source: BoE, table 5.A, page 34, November Inflation Report 2017 Berenberg.

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